PROFESSIONAL CAREER CLUB

FREE CERTIFICATION PREP

REVISION NOTES

CFA Level II: Recall & Confusion Pairs

Memory hooks and the look-alikes that cost marks

12 memory hooks **15** confusion pairs

HOW TO USE THIS

Level II is a vignette exam. The formula is rarely the hard part — finding the right three inputs in a page of narrative usually is, and choosing the right MODEL almost always is.

So the confusion pairs here are different in kind from Level I. At Level I you confuse two formulas. At Level II you confuse two frameworks, and the cost is not one mark but a whole item set, because a wrong input propagates through all six questions.

Part 1 is memory hooks. Part 2 is the pairs — and several of them are about WHICH MODEL to reach for, which is the distinctly Level II skill.

Rehearse the hooks aloud. Self-test the pairs by covering one column and reconstructing it. Reading is worth very little at this level.

PART 1 — MEMORY HOOKS · 12 hooks

Each one regenerates a rule rather than storing it. That is what survives a four-hour exam.

"The issuer owns the call."

Unlocks: Callable ⇒ OAS < Z-spread. Putable ⇒ OAS > Z-spread.

▸ *OAS = Z-spread − option value. The call belongs to the ISSUER, so you subtract. The put belongs to YOU, so it adds. Rebuild it from who owns the option and you never memorise a direction again.*

"Vol raises both options."

Unlocks: Higher assumed interest-rate volatility raises the value of BOTH embedded options.

▸ *So the callable's price FALLS (the issuer's option is worth more) and the putable's price RISES (yours is worth more). Same cause, opposite effect — and the exam asks for exactly this comparison.*

"Own the post."

Unlocks: Investor share = Investment / POST-money valuation.

▸ *Post-money = pre-money + new investment. Dividing by pre-money overstates the stake, and that answer is always among the options.*

"Risk-neutral is not anyone's forecast."

Unlocks: Binomial option pricing uses risk-neutral probabilities.

▸ *$\pi_u = [(1 + r) − d] / (u − d)$. Nobody's expected return enters this. The investor's actual view of the stock is irrelevant to the option's price — the single most counterintuitive idea in derivatives, and a reliable conceptual question.*

"Terminal value lands at n, not n + 1."

Unlocks: Two-stage DDM and any multi-stage model.

▸ *$V_n = D_{n+1}/(r − g_L)$ is a value AS AT time n. Discount it n periods, not n + 1. This off-by-one is the most common Level II valuation error there is.*

"Book value first, terminal value last."

Unlocks: Residual income is robust; DDM is not.

▸ *RI starts from B_0 — most of the value arrives immediately. So RI depends far less on the terminal value than a DDM does, which is exactly why it is preferred for firms with no dividends and negative near-term cash flow.*

"ROE > r_e, or the firm is worth book."

Unlocks: Residual income and justified P/B.

▸ *Justified P/B = (ROE − g)/(r − g). If ROE equals the cost of equity, P/B = 1 and residual income is zero. A firm earning exactly its cost of capital creates nothing.*

"Errors break the standard errors. Omissions break the coefficients."

Unlocks: The three regression violations.

▸ *Heteroskedasticity and serial correlation corrupt the STANDARD ERRORS, so the t-stats lie but the coefficients stay unbiased. Multicollinearity inflates them. An OMITTED variable biases the coefficients themselves. Three problems, three different damages.*

"High R^2, nothing significant ⇒ multicollinearity."

Unlocks: The fingerprint, in one line.

▸ *The model explains a lot jointly but cannot attribute it to any single regressor, because the regressors move together. VIF > 10 confirms it. Note: it does NOT bias the coefficients.*

"FCFF meets WACC. FCFE meets cost of equity."

Unlocks: The cash flow / discount rate pairing, and where the FCFE bridge starts.

▸ *From EBIT, interest never appears — it was never deducted. From NET INCOME, it is already gone, so do not add it back to FCFE. The starting point dictates the adjustment.*

"Covered holds. Uncovered does not."

Unlocks: The parity conditions.

▸ *Covered interest parity is enforced by ARBITRAGE, so it holds. Uncovered parity relies on EXPECTATIONS, so it fails empirically — and that failure is exactly what the carry trade harvests.*

"A high discount rate shrinks the liability."

Unlocks: Pension accounting and earnings quality.

▸ *Management picks the discount rate (smaller liability) and, under US GAAP, the expected return on plan assets (flattered earnings). Both are levers. When a question mentions either assumption, it is asking about earnings quality.*

REMEMBER

- Say these aloud. At Level II the exam is long and your recall degrades; a spoken hook survives fatigue far better than a read one.
- The strongest hooks here encode OWNERSHIP or CAUSATION, not sequence. If you forget "the issuer owns the call", you can still derive it. If you forget an acronym, you have nothing.

PART 2 — CONFUSION PAIRS · 15 pairs

Several of these are model-selection questions in disguise — the distinctly Level II failure mode.

OAS vs Z-spread

Z-spread	OAS
• Zero-volatility spread	• Z-spread MINUS the option cost
• Ignores the embedded option entirely	• Strips out the optionality
• Overstates compensation on a callable	• The like-for-like credit comparison

THE SEPARATOR **Callable ⇒ OAS < Z-spread. Putable ⇒ OAS > Z-spread. Derive it from who owns the option.**

▸ *Only OAS lets you compare bonds with different embedded options. Comparing Z-spreads across a callable and a bullet is comparing two different things.*

Which valuation model?

Dividend discount model	Residual income
• Stable, established dividend payer	• No dividends, negative near-term FCF
• Minority (non-control) perspective	• Value arrives up front via book value
• Needs a predictable payout	• Less dependent on terminal value

THE SEPARATOR **No dividend and no free cash flow ⇒ residual income. That is the model the exam is steering you toward.**

▸ *FCFF is the CONTROL perspective — an acquirer can change the payout, so dividends are irrelevant to them. Model choice follows the perspective.*

Heteroskedasticity vs multicollinearity

Heteroskedasticity	Multicollinearity
• Non-constant error variance	• Regressors correlate with each other
• Coefficients stay UNBIASED	• Coefficients stay UNBIASED
• Standard errors are wrong ⇒ t-stats lie	• Standard errors INFLATED ⇒ nothing significant

THE SEPARATOR **Both leave the coefficients unbiased. Only an OMITTED VARIABLE actually biases them.**

▸ *The multicollinearity tell: high R^2, high F-stat, but no individual t-stat is significant. The model works; it just cannot say which variable is doing the work.*

R^2 vs adjusted R^2

R^2	Adjusted R^2
• RSS / SST	• Penalises the regressor count
• Never falls when a variable is added	• CAN fall
• A useless variable still raises it	• Falls whenever the new $\|t\| < 1$

THE SEPARATOR **R^2 always rises. Adjusted R^2 only rises if the variable earned its place.**

▸ *If adding a variable lowers adjusted R^2, that variable is noise — which is a complete, examinable conclusion in itself.*

Covered vs uncovered interest parity

Covered (CIP)	Uncovered (UIP)
• $F/S = (1 + r_d)/(1 + r_f)$	• Same equation, but for EXPECTED spot
• Enforced by ARBITRAGE	• Relies on expectations
• Holds in practice	• Fails empirically

THE SEPARATOR **Covered uses the forward and holds. Uncovered uses an expectation and does not.**

▸ *The carry trade exists precisely because UIP fails — the high-yield currency does not depreciate as much as UIP says it should. That failure is a persistent, harvestable anomaly.*

MM with taxes vs MM with distress costs

MM with taxes	MM + distress costs
• $V_L = V_U + tD$	• Tax shield minus PV of distress
• The tax shield adds value linearly	• An INTERIOR optimum exists
• Implies 100% debt is optimal	• The static trade-off theory

THE SEPARATOR **Pure MM-with-taxes says all debt. The exam wants you to name what it leaves out: financial distress, agency costs, asymmetric information.**

▸ *The progression is the question: no taxes ⇒ irrelevance; taxes ⇒ all debt; taxes + distress ⇒ an optimum. Identify which world the vignette is in.*

Gamma vs vega

Gamma	Vega
• Sensitivity of DELTA to the underlying	• Sensitivity of VALUE to volatility
• Highest ATM and near expiry	• Highest ATM with LONG expiry
• Makes delta-hedging expensive	• Positive for long calls AND long puts

THE SEPARATOR **Gamma peaks near EXPIRY. Vega peaks with LONG time remaining. Opposite ends of the maturity spectrum.**

▸ *Both are highest at the money. It is the maturity behaviour that separates them, and that is what the exam tests.*

US GAAP vs IFRS pension expense

US GAAP (ASC 715)	IFRS (IAS 19)
• Uses EXPECTED return on plan assets	• NET INTEREST on the net liability
• Actuarial G/L can be amortised into P&L	• Remeasurements go to OCI and STAY there
• Management can flatter earnings	• Less room to manage earnings

THE SEPARATOR **US GAAP lets management assume a heroic return on assets. IFRS does not — it imposes the discount rate on both sides.**

▸ *This is an earnings-quality question, not an accounting one. When the vignette gives you an assumed return, it is inviting you to comment on it.*

Callable vs putable price behaviour

Callable	Putable
• Issuer redeems when rates FALL	• You sell it back when rates RISE
• Price compression near the call price	• Price floor near the put price
• NEGATIVE convexity at low yields	• Positive convexity throughout

THE SEPARATOR **The callable is capped on the upside. The putable is floored on the downside.**

▸ *Draw the price-yield curve. The shape answers every question in this topic faster than any formula will.*

FCFF from EBIT vs from net income

Starting from EBIT	Starting from net income
• EBIT(1 − t) + D&A − ΔWC − CapEx	• NI + NCC + Int(1 − t) − ΔWC − CapEx
• Interest NEVER appears	• Interest MUST be added back
• It was never deducted	• It was already deducted

THE SEPARATOR **The starting point dictates the adjustment. Adding interest back twice is the classic double-count.**

▸ *Write down which line item you started from before you touch a number. The vignette will give you both, deliberately.*

Build-up method vs CAPM

CAPM	Build-up method
• $r_e = R_f + \beta(ERP)$	• R_f + ERP + size + specific + industry
• Needs an observable beta	• NO beta at all
• Requires a traded price series	• For private / illiquid firms

THE SEPARATOR **Private company ⇒ no price series ⇒ no beta ⇒ build-up. The absence of beta is the whole point.**

▸ *The specific-company premium is where all the judgement (and all the abuse) lives. Expect a question about its subjectivity.*

Sustainable growth vs forecast growth

Sustainable growth (g = ROE × b)	Forecast growth
• Fundable from retained earnings alone	• Whatever the analyst assumes
• No new equity, no more leverage	• May exceed sustainable growth
• A structural ceiling	• Then it needs external financing

THE SEPARATOR **If forecast growth exceeds g = ROE × b, the firm must raise capital. Say so — that is the marked point.**

▸ *Terminal growth can never exceed long-run nominal GDP growth either. If a vignette implies it does, that is the assumption you are meant to reject.*

Expected loss vs credit spread

Expected loss (PD × LGD)	Observed credit spread
• The actuarial cost of default • Provisioned for and priced in	• Expected loss + risk premium + liquidity premium • Much WIDER than expected loss alone

THE SEPARATOR **The spread is far wider than expected loss. The gap is why long-run credit returns exceed default losses.**

▸ *If a question asks why investment-grade credit has beaten Treasuries despite defaults, this gap IS the answer.*

Direct capitalisation vs DCF (real estate)

Direct capitalisation	Discounted cash flow
• $V = NOI_1$ / cap rate • Requires STABILISED NOI • Fails on a half-let building	• Explicit forecast + terminal value • Handles lease-up and refurbishment • Needs an exit cap rate

THE SEPARATOR **No stabilised NOI ⇒ no direct capitalisation. Use DCF.**

▸ *Cap rate = r − g. A low cap rate signals expected GROWTH, not a cheap building. That relationship is the Gordon model in a hard hat.*

TVPI vs DPI

TVPI	DPI
• (Distributions + NAV) / paid-in • Includes UNREALISED value • The GP marks the NAV themselves	• Distributions / paid-in • Cash actually returned • Cannot be flattered by a mark

THE SEPARATOR **DPI is money in the bank. TVPI is money in the bank plus the GP's opinion.**

▸ *Early in a fund's life, TVPI is almost entirely opinion. Ask what share of TVPI is DPI — that ratio tells you whether the GP can actually exit.*

REMEMBER

- At Level II, model SELECTION is itself an exam question. Before computing, ask: which model does this vignette want, and why did they rule out the others?
- When you get an item set wrong, identify whether it was the wrong formula, a wrong INPUT, or a misread. Wrong inputs are the Level II speciality, and they are a reading problem, not a knowledge problem.

HOW TO USE THIS IN THE LAST MONTH

The vignette discipline

- Read the QUESTIONS first, then the vignette. You will read half the narrative knowing it is irrelevant — that is the point.
- Vignettes contain deliberately unused data. An unused number is not evidence that you missed a step.
- Footnotes under exhibits carry more information per word than anything else on the page. Read them.

Self-test, do not re-read

- Cover one column of each pair and reconstruct it from the other. If you cannot, that pair is a live weakness.
- Say the hooks aloud once a day. Thirty seconds, and it is the cheapest revision you will do.

Where the marks actually go

- Ethics is the largest single topic and the cheapest to improve. Do not leave it to the final week.
- Practise in full six-question item sets under time — 18 minutes. Isolated questions do not build the skill Level II is testing.
- One wrong input can cost you a whole item set. That makes careful reading a higher-return skill than any additional formula.